

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Knight Analyst: John Pavalasky Bill Number: SB 935  
Related Bills: See Legislative History Telephone: 845-4335 Introduced Date: February 21, 2003  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Exclusion/Gain From Sale Of New, Direct, Long-Term Investment In Stock Of Small Corporation

### SUMMARY

This bill would not tax any gain from the sale of stock (held for three years) acquired directly from any corporation having \$300 million or less of paid in capital.

### PURPOSE OF THE BILL

According to the author's office the purpose of this bill is to encourage direct investment in small corporations.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and apply to taxable years beginning on or after January 1, 2003.

### POSITION

Pending.

### Summary of Suggested Amendments

It appears that the author intends the definition of "long-term" to be stock held for three years or more. The bill, however, does not contain the phrase "or more" and thus, only stock held exactly three years would qualify. To make stock held longer than three years eligible, the definition of "long-term" on page 2, lines 3 and 24 should be amended to insert "or more" at the end of the sentence.

### ANALYSIS

#### FEDERAL/STATE LAW

Under federal law, noncorporate taxpayers can exclude 50% of any gain from the sale or exchange of qualified business stock held for more than five years. There is a cumulative limit of \$10 million of gain a taxpayer can exclude from a single issuer. For purposes of the alternative minimum tax (AMT), 28% of the excluded gain is a preference item (42% for stock with a holding period beginning before January 1, 2001).

Board Position:

<input type="checkbox"/> S	<input type="checkbox"/> NA	<input type="checkbox"/> NP
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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director  
Gerald H. Goldberg

Date  
04/01/03

To be eligible as qualified small business stock under federal and California law, the stock must be issued after August 10, 1993, and acquired by the taxpayer at its original issue (directly or through an underwriter) in exchange for money, property, or as compensation for services provided to the corporation. The corporation must have aggregate gross assets that do not exceed \$50 million as of the date of issuance. In addition, at least 80% of the value of the corporation's assets must be used in the active conduct of one or more qualified businesses (commonly called the "active business requirement"). The performance of services in the fields of health, law, engineering, and architecture is not a qualified trade or business. In addition, the hospitality, farming, insurance, financing, or mineral extraction industries are not qualified businesses.

California generally follows the federal rules allowing 50% of the gain from the sale or exchange of qualified business stock held for more than five years to be excluded from gross income but imposes a more stringent "active business requirement" designed to target the incentive to investments in California small businesses. Under the California "active business requirement," the stock will not qualify for the California exclusion unless at least 80% of the payroll of the corporation issuing the stock is attributable to employment located within California on the date of issue and for substantially all of the holding period. For purposes of AMT, 50% of the excluded gain is a preference item.

### THIS BILL

This bill would exclude 100% of the gain from the sale or exchange of stock acquired directly from a small corporation by either corporate or noncorporate taxpayers, that has been held for three years. This bill would also exclude 100% of the gain from the AMT.

This bill would require the stock to be newly offered after the effective date of the act, be acquired directly from the corporation issuing the stock, and held by the investor for three years or more. In addition, the corporation issuing the stock may not have more than \$300 million in paid in capital.

### IMPLEMENTATION CONSIDERATIONS

This bill uses terms that are undefined, i.e., 'equity share,' and 'investment in the stock of a small corporation.' Also, it is unclear whether the corporation is required to meet the \$300 million asset test only at issuance or also at the time of sale. The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this exclusion.

### **LEGISLATIVE HISTORY**

AB 1603 (Bates, 2002/2003) would not tax any gain from the acquisition, sale, or exchange of a stock option in a California high technology business by an investor in the business or by an employee, officer, or director of that business.

AB 2358 (Bates, 2001/2002) contained substantially the same language as AB 1603, but failed to pass out of the Assembly Revenue and Taxation Committee.

SB 671 (Stats. 1993, Ch. 881) enacted the exclusion of 50% of the gain from the sale of California small business stock acquired directly from the issuing corporation and held for five years or more.

## OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not have a personal income tax. However, the remaining states, for noncorporate taxpayers, do conform to the federal exclusion of 50% of gain from the sale of small business stock acquired directly from the issuing corporation and held for five years or more. None of the states provide an exclusion from income for corporate taxpayers making direct investments in small corporations comparable to the exclusion allowed by this bill.

## FISCAL IMPACT

If this bill is amended to resolve the implementation considerations addressed in this analysis, the bill would not significantly impact the department's costs.

## ECONOMIC IMPACT

### Revenue Estimate

This bill is estimated to result in revenue losses as follows:

Estimated Revenue Impact of SB 935 As Introduced February 21, 2003 Effective with Stock Issued After Enactment Date* \$ Millions				
2003-04	2004-05	2005-06	2006-07	2007-08
-\$0	-\$0	-\$5	-\$25	-\$45

\* Assumed for this estimate to be August 1, 2003.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Discussion

For purposes of this estimate it is assumed that this bill would be enacted by 8/1/2003. Thus, the first taxable year to be impacted by this bill is 2006, when the stocks purchased during the 8/1/2003-12/31/2003 period meet the three-year holding period requirement.

The revenue impact of this bill is estimated as the product of the amount of stock gains realized, the fraction of these gains qualified under this bill, and the applicable marginal tax rate.

Using that formula, the revenue loss for the 2006 taxable year is estimated at \$7 million ( $\$50,000 \text{ million stock gains} \times 0.15\% \text{ qualifying fraction} \times 9\% \text{ tax rate} = \$7 \text{ million}$ ). This 2006 taxable year revenue loss of \$7 million, when restated on a 2005-2006 fiscal year basis, results in a \$5 million revenue impact due to the reduction that would be made to the last two estimate payments made during that fiscal year. The first full fiscal year impact is shown in the 2006-2007 estimate.

The revenue impact of this bill would be greater in later years as more and more stocks qualify, reaching a revenue loss of about \$100 million in 2010.

The amount of stock gains realized (\$50,000 million) is estimated for the year 2000 using the Department's capital gains sample. This year 2000 amount is extrapolated to future years using the Department of Finance's projection of capital gains growth.

The fraction of the above gains that would qualify under this bill depends on the estimated percentage of current gains that meet the holding-period requirement and the small-corporation requirement. For the first taxable year, 2006, this fraction is estimated to be 0.15%.

The applicable marginal tax rate is assumed to be 9% due to the allowance of this exclusion to corporations as well as to higher income venture capital investors.

## **ARGUMENTS/POLICY CONCERNS**

This bill would provide an incentive to invest in any corporation with \$300 million of paid in capital, regardless of whether the corporation is domiciled or doing business in California. The author may wish to include a California "active business requirement" similar to the requirement in current law pertaining to qualified small business stock.

## **LEGISLATIVE STAFF CONTACT**

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